

**Controls Over the Employer Abatement
Program Cases Can Be Improved**

July 2003

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

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FROM: Gordon C. Milbourn III
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Corporate Programs)

SUBJECT: Final Audit Report - Controls Over the Employer Abatement
Program Cases Can Be Improved (Audit # 200230039)

This report presents the results of our review of the Internal Revenue Service's (IRS) Employer Abatement Program. The overall objective of this review was to determine whether the Small Business/Self-Employed (SB/SE) Division's Compliance function is effectively working Employer Abatement Program cases and if actions are being taken to prevent noncompliance.

Identifying and combating abusive tax schemes are among the highest compliance priorities within the SB/SE Division's Compliance function. One of the abusive tax schemes being targeted by the IRS is the "I.R.C. 861¹ Stop-Filing Scheme," also known as the "Employer Abatement Program." Taxpayers using this scheme are claiming that wages are not taxable because they do not meet the legal definition of gross income.² Promoters advised employers to stop withholding or paying payroll taxes on their employees' wages. In addition, these taxpayers are filing amended payroll tax returns to request refunds of previously paid payroll taxes. Not identifying participants of this abusive tax scheme could result in a significant loss of tax revenue to the Federal Government, negatively affect voluntary compliance, and possibly increase the chances for the filing of additional frivolous returns.

¹ I.R.C. refers to the Internal Revenue Code, also known as 26 U.S.C., and 861 refers to the specific section within the I.R.C..

² I.R.C. § 61 (1994 & Supp. IV 1998) defines gross income as all income from whatever source derived, such as compensation for services, gain from dealings in property, interest, etc.

In summary, the IRS has taken various actions to identify promoters of this scheme and to prevent further noncompliance. One of the major achievements is that the Department of Justice filed for injunctions on nine promoters, eight of which have been issued. Another nine promoters are still under investigation. The IRS issued several news releases stating the IRS' position, alerting taxpayers to this scheme, and advising them of their tax responsibilities. The IRS also had interviews with national media sources. Our review of 60 cases showed that examiners properly determined whether there were true employer abatement issues and properly developed the issues on the cases.

Although the IRS took various actions to prevent noncompliance and worked cases effectively, we identified three areas where the project can be improved. First, controls over cases need improvement to account for cases and better measure the results of the project. Our review showed that only 233 of the 480 Employer Abatement Program cases were controlled on the Examination function's automated inventory system. In addition, examiners did not complete referral worksheets in 25 of the 60 cases sampled.

Second, we determined that cases need to be started more timely. Although the instructions for the project required that cases be started within 30 days of receipt, in 12 of 54 cases sampled examiners did not start working the cases within the required 30 days.

Finally, 45 of the 60 taxpayers in our sample did not meet the criteria to be worked under the project. The process for screening cases to determine whether there were employment abatement issues was not effective in either the Frivolous Return Program function or the Compliance field offices.

We recommended that the Director, Compliance, SB/SE Division, gather and summarize the best information available on examinations conducted to date, reemphasize the need to update the referral worksheets and the priority for working these cases, and reevaluate the screening process.

Management's Response: Management's response was due on July 14, 2003. As of July 18, 2003, management had not responded to the draft report.

Copies of this report are also being sent to IRS officials who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Director (Submission Processing), at (631) 654-6028.

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Controls Over the Employer Abatement Program Cases Can Be Improved

Background

The Internal Revenue Service's (IRS) mission is to provide top-quality service to taxpayers by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. To meet the mission, the IRS has a tax compliance program that includes the examination of certain tax returns to ensure that the proper amount of tax is assessed. Among the highest compliance priorities within the IRS' Small Business/Self-Employed (SB/SE) Division's Compliance function are identifying and combating abusive tax schemes.

One of the abusive tax schemes being targeted by the IRS is referred to as the "I.R.C. 861¹ Stop-Filing Scheme," also known as the "Employer Abatement Program." Taxpayers using this scheme are claiming that wages are not taxable because they do not meet the legal definition of gross income.² Promoters of the scheme advise employers to stop withholding or paying payroll taxes on their employees' wages. In addition, these taxpayers are filing amended payroll tax returns³ to request refunds of previously paid payroll taxes or filing original returns and having no wages. There are a number of promoters selling the Employer Abatement Program scheme to taxpayers.

To centralize the control of potentially false and frivolous returns, the Frivolous Return Program (FRP) function was consolidated in January 2002 at the Ogden Campus.⁴ Employees at various IRS campuses identify returns where employers file employment tax returns meeting a specific profile and forward the cases to the FRP function where they are entered into a database. The FRP function then sends correspondence to the taxpayers advising them that they may be participating in an employer abatement

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² I.R.C. § 61 (1994 & Supp. IV 1998) defines gross income as all income from whatever source derived, such as compensation for services, gain from dealings in property, interest, etc.

³ The payroll tax return is used to determine the employment tax liability, including income tax withheld from wages paid.

⁴ The campuses are the data processing arms of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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program scheme and requesting additional information. Based on the taxpayers' responses and certain criteria, the FRP function sends the returns to the Planning and Special Programs (PSP) function in various field offices for further investigation. The PSP function is responsible for planning and monitoring the inventory of tax returns assigned for examination.

Not identifying participants of abusive tax schemes could result in a significant loss of tax revenue to the Federal Government. In addition, it could negatively affect voluntary taxpayer compliance and possibly increase the chances for the filing of additional frivolous returns.

We conducted the audit from October 2002 to March 2003 in the SB/SE Division's Compliance Area Office in Dallas, Texas, and at the Ogden Campus. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Compliance Function Took Various Actions to Prevent Noncompliance

The IRS took various actions to identify promoters of these schemes and to prevent further noncompliance. One of the major achievements is that the Department of Justice filed for injunctions on nine promoters, eight of which have been issued. Another nine promoters are still under investigation. These injunctions order the promoters to stop organizing, promoting, marketing, or selling the Employer Abatement Program scheme and any other abusive tax shelter, plan, or arrangement. Also, the injunctions order the promoters to stop preparing frivolous tax returns and provide a complete client list to the Federal Government.

In addition to sending letters to investors, the IRS issued several news releases stating the IRS' position, alerting taxpayers to this scheme, and advising them of their tax responsibilities. The IRS also held interviews with national media sources and established a web site with information on this tax scheme. In addition, Compliance function employees attended training sessions instructing them on how to identify and work Employer Abatement Program cases.

Controls Over the Employer Abatement Program Cases Can Be Improved

The FRP function maintained a database to control all potential Employer Abatement Program cases received from the other campuses. As of July 29, 2002, there were 1,841 potential Employer Abatement Program cases entered on the FRP database. The FRP function informed us that 480 had been forwarded to the PSP function as of August 22, 2002, for potential assignment to examiners. Examiners were given specific procedures for working the cases and instructions to complete a case feedback form. The feedback form, called the I.R.C. 861 Program Referral Worksheet, was intended to capture an updated status and result of each case for input to the FRP database.

We reviewed 60 judgmentally sampled cases and determined that the examiners effectively worked the cases once they were assigned. Our review showed that the examiners properly determined whether there were true employer abatement issues and properly developed the issues on the cases. In 53 of the 60 cases, the examiners made the proper determinations on whether there were employer abatement issues; the other 7 cases were still open and no determination had been made at the time of our review.

The Compliance Function Needs to Improve Controls Over Cases to Better Measure the Success of the Project

Although we determined that examiners worked the cases effectively, we had difficulty identifying those cases included in the project that were sent to the PSP function and then assigned to the examiners for further investigation. The Compliance function field offices have two processes in place that could have been better used for tracking and controlling cases:

- The Audit Information Management System (AIMS), which is a computer system designed to give Examination information about returns in inventory and closed.
- The I.R.C. 861 Program Referral Worksheet, which is intended to provide a means for monitoring the status and results of the Employer Abatement Program cases.

In addition, Compliance function management issued a memorandum with instructions for working the project's cases. The instructions gave PSP managers the

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responsibility to control the Employer Abatement Program cases forwarded to and received in the field offices.

We determined that the two processes to control cases were not properly used. Our review showed that the PSP function controlled on the AIMS only 233 of the 480 cases the FRP function shows as being sent to the PSP function. The PSP function was able to manually identify another 82 cases but could not account for the remaining 165 cases.

Finally, the directives for the project instructed examiners to complete the referral worksheets after initial research and analysis of the case files and provide periodic updates of the examinations to the FRP function so its database could be updated. However, examiners did not complete the referral worksheets and submit them to the FRP function in 25 of the 60 cases sampled.

The primary cause for not controlling the cases on the AIMS was that these cases were considered “leads.” Compliance function management officials informed us that the Employment Tax Group⁵ (where the majority of these cases were forwarded) considers all of its cases “leads” and, therefore, does not immediately control cases on the AIMS. After cases are screened, the Group determines if the cases have potential to be productive examinations and then controls them on the AIMS. Cases not selected for assignment are returned to files in the campuses. For this project, cases are returned to the FRP function. This may be 1 of the reasons why the PSP function could not account for the 165 cases. In addition, Compliance function managers did not follow up to ensure employees were completing the referral worksheet.

As a result, Compliance management was unable to develop a meaningful report to monitor the effectiveness of the project in addressing tax schemes. In addition, returns could become lost and examinations not conducted when necessary.

⁵ The goal of the Employment Tax Group is to ensure that all payments subject to employment tax are reported. It conducts examinations related to employment tax matters.

Controls Over the Employer Abatement Program Cases Can Be Improved

During our audit, Compliance function management took actions to improve the controls over cases. Compliance function management officials informed us they revised procedures so that all cases referred to the PSP function are established on the AIMS. Returns are now being controlled on the AIMS before they are sent from the FRP function to the field offices.

Recommendations

The Director, Compliance, SB/SE Division, who is responsible for implementing policies for the Examination function, should:

1. Gather and summarize the best information that is currently available on completed examinations to determine the effectiveness of the project.

Management's Response: Management's response was due on July 14, 2003. As of July 18, 2003, management had not responded to the draft report.

2. Reemphasize to examiners and managers the need to update the referral worksheets.

The Compliance Function Was Not Always Working Potential Employer Abatement Cases Timely

The IRS considers the project addressing the Employer Abatement Program a high priority. Project instructions identify the employer returns as "must work" cases, and they should be started within 30 days of receipt of the return by the examiner.

Although we determined that cases were properly worked regarding the issues, examiners did not always begin working the cases timely. For the 60 cases reviewed, we could make a timeliness determination for 54 cases.⁶ We determined that in 12 of the 54 cases, examiners did not start working the cases within the required 30 days. For 8 of these 12 cases, the range of days to start the examinations was 41 to 263 days, with an average of 94 days. The remaining 4 cases had not been started as of the date of our review, but Compliance function managers

⁶ Three of the 60 cases reviewed were assigned before the project started, and 3 other cases did not have sufficient documentation from which to make a timeliness determination.

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informed us that these cases had been assigned for more than 30 days.

The majority of the cases that were not timely worked did not actually have the employer abatement issue, so the examiners may not have considered them a priority. Compliance function managers did not follow up to ensure the cases were started timely.

When cases are not timely worked, the Compliance function is not meeting its goal of promptly addressing taxpayer compliance. Also, for those cases in which the employer abatement issues were not present, the refunds on legitimate claims were delayed, causing poor taxpayer relations and increased burden.

Recommendation

3. The Director, Compliance, SB/SE Division, should reemphasize the priority of timely working these cases to both the examiners and managers and assign follow-up responsibility.

Many Cases Did Not Meet the Project's Criteria

As stated previously, examiners were effectively working those cases that actually had employer abatement issues. However, most of the taxpayers in our sample were not actually claiming the employer abatement issue and were instead making legitimate claims.

The FRP function uses specific screening criteria to identify those cases that should be included in the project. The FRP function forwards those cases that require further consideration to the Compliance function field offices where additional screening is done. Prior to assigning the cases to examiners, the Compliance function field offices also screen the cases to determine if the cases have potential to be productive examinations.

Even though these 2 screening attempts were conducted, our sample review of cases assigned to examiners showed that an employer abatement issue actually existed in only 9 of the 60 cases. An additional six cases had other questionable issues that needed to be resolved by an examiner and warranted examination. However, the

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remaining 45 cases did not meet the criteria to be worked under the project. Of the 45 cases:

- Twenty-five had subsequent returns filed. Subsequent returns indicate the taxpayers are continuing to pay employment taxes.
- Seventeen had indications that the returns were legitimate claims for refunds because they were either final returns or no wages were paid. Although at first glance they might appear to meet the criteria for the project, there was enough supporting information in the files to show the taxpayers went out of business or had no employees.
- Three had taxpayers requesting the overpayments be applied to the subsequent modules. This indicates that the taxpayers are not asking for a refund of taxes.

Two factors contributed to cases being assigned to examiners that did not meet the project's criteria. First, the FRP function apparently misclassified a portion of its inventory as potential Employer Abatement Program cases. Another Treasury Inspector General for Tax Administration review is being conducted to evaluate those controls in the Ogden Campus, and the results will be presented in a separate audit report. In addition, Compliance function managers did not properly screen the cases and allowed cases to be assigned that did not meet the project's criteria.

The Compliance function field offices have limited resources to work cases. If cases were properly screened, examiners' time could be more effectively used for only those cases that meet the project's criteria and are in the most need of examination.

Recommendation

4. The Director, Compliance, SB/SE Division, should reevaluate the screening process to help ensure that only cases that meet the project's criteria are selected for examination.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Small Business/Self-Employed (SB/SE) Division's Compliance function is effectively working Employer Abatement Program cases and if actions are being taken to prevent noncompliance.

We conducted the following tests to accomplish the objective:

- I. Determined the Internal Revenue Service's (IRS) procedures and key controls for Employer Abatement Program cases.
 - A. Reviewed instructions and guidelines issued to the Compliance function.
 - B. Obtained from the Frivolous Return Program (FRP) function a copy of the database with 1,841 potential Employer Abatement Program cases as of July 29, 2002.
 - C. Performed research on the IRS computer systems for 480 of the 1,841 potential Employer Abatement Program cases that were referred to the Planning and Special Programs (PSP)¹ function for further investigation.
 - D. Determined how the Compliance function is measuring the progress and effectiveness of the project addressing the Employer Abatement Program.
- II. Determined the effectiveness of IRS employees' actions on Employer Abatement Program cases. We reviewed the cases obtained from the FRP database to accomplish this subobjective.
 - A. Identified the assignment status of the 480 cases forwarded to the PSP function and not yet controlled on the Audit Information Management System (AIMS).²
 - B. Performed an analysis of the cases in the PSP function not yet assigned to an employee and identified trends, including timeliness in case assignment and initiation process.
 - C. Reviewed cases worked in the Compliance function field offices and determined if cases were effectively worked.
 1. Selected judgmental samples of 40 closed cases nationwide and 20 open cases in 1 office where taxpayers filed amended employment tax returns meeting the Employer Abatement Program scheme's criteria. We used judgmental samples because we could not identify the population of cases due to the IRS' incomplete records of cases in this project.

¹ The PSP function, which is within the Compliance function, plans and monitors the inventory of tax returns for examination.

² The AIMS is a computer system designed to give Examination information about returns in inventory and closed.

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We selected closed cases from 174 project cases that were shown as closed on the on the FRP database and/or the Examination function's automated inventory system. These included both cases that the IRS concluded did not claim the Employer Abatement Program scheme and those that did. For the open cases, we selected all open project cases in the Dallas, Texas, Area Office based on cases in inventory on a specific date.

2. Requested the history files of the cases.
 3. Identified the collection status of the cases.
 4. Determined if employer abatement issues were properly addressed.
 - D. Discussed with SB/SE Division Compliance function management the results of the IRS' actions on Employer Abatement Program cases.
- III. Determined whether the Compliance function took effective actions to prevent noncompliance.
- A. Identified actions taken by the IRS to reach out to the small business community.
 - B. Performed research through the IRS Intranet or Internet and identified any formal communications issued.

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Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 165 taxpayer cases affected (see page 3).

Methodology Used to Measure the Reported Benefit:

There were 480 project cases that the Frivolous Return Program (FRP) function showed as being sent to the Planning and Special Programs (PSP) function.¹ Our review showed that the PSP function controlled on the Audit Information Management System (AIMS)² only 233 of the 480 cases the FRP function shows as being sent to the PSP function. The PSP function was able to manually identify another 82 cases but could not account for the remaining 165 cases.

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